THEMATIC REPORT | Spotlight on MFRS 16 Leases

8 August 2019

Nabil Zainoodin, CFA, CA
nabil.zainoodin@midf.com.my
03-2772 1663

KEY HIGHLIGHTS

- **1QCY19 earnings season represents the first quarterly impact of MFRS 16, with noticeable earnings impact on the retail, airlines and healthcare industries**
- **Among the companies under our universe of stock coverage, we view that Aeon Co (M) Bhd, AirAsia Group Bhd and KPJ Healthcare Bhd will be negatively impacted the most**
- **Meanwhile, we expect Padini Holdings Bhd's 1QFY20 earnings to show mid-single digit downward impact post the adoption of MFRS 16**
- **Insurance will be the next industry to be impacted post the implementation of MFRS 17 Insurance Contract in 2021 which will lead to a complete overhaul of the financial statements**

The new accounting standards aim to enhance reliability of financial statements. The recent adoption of Malaysian Financial Reporting Standards (MFRS) 16 Leases starting from 1st January 2019 is the third major accounting standards implemented since 2018. To recall, the other two standards namely MFRS 9 Financial Instrument and MFRS 15 Revenue from Contracts with Customers were adopted from 1st January 2018 onwards. Moving forward, in 1st January 2021, insurance and takaful companies will have to apply MFRS 17 Insurance Contract which stem from the International Financial Reporting Standards (IFRS). By becoming fully IFRS compliant, the financial statements of public listed companies will become more transparent and reliable. Consequently, this will improve the credibility of the Malaysian capital market.

MFRS 9 introduced a more forward looking perspective on impairments. During the 2008 global financial crisis, the delayed recognition of credit losses on loans and other financial instruments was identified as a weakness in the previous accounting standard. Hence, MFRS 9 replaces the previous incurred loss impairment model with a more forward-looking expected credit loss model. As a result, it is no longer necessary for a credit event to have occurred before impairment losses are recognised. The financial services sector was the most impacted as it changes the way banks do business, allocate capital, and manage the quality of loans and provisions.

MFRS 15 scrutinises the recognition of revenue. Revenue growth is one of the main indicators which is closely monitored by fund managers and analysts. Due to this, MFRS 15 aims to provide useful information about the nature, amount and timing of revenue and cash flows arising from a company's contracts with customers. For instance, the standard changes the criteria for determining whether revenue is recognised at a point in time or over time. For a telecommunication service provider, more revenue associated with a subsidised handset are recognised at the start of the contract and less revenue as the contract continues regardless of the pattern of billings.

MFRS 17 represents a complete overhaul of accounting for insurance contracts. MFRS 17 will significantly change the way insurance and takaful companies recognise revenue and profits from insurance contracts. The standard requires revenue, which primarily premiums and profit earned from the insurance contract, to be recognised over the period that the insurer provides coverage. This will apportion the revenue and profit over the lifespan of a contract as opposed to the current practice of recognising majority of the profit upfront. While this practice is reasonable, given the fact that it is consistent with the way other industries recognise revenue form long term contracts, we view that affected companies will show notable impact on their earnings especially upon the first year of implementation.

MFRS 16 requires existing off-balance sheet lease to be reassessed. MFRS 16 requires company to reassess existing off-balance sheet lease i.e. operating lease. The new lease standard introduced substantial changes to how lessee would recognise a lease contract while little changes are required for lessors. The previous version of MFRS 117 was criticised for failing to meet the needs of users of financial statements because it did not always provide a true representation of leasing transactions. In particular, it did not require lessees to recognise assets and liabilities arising from operating leases despite the fact that lessees have the right to use assets and incur liabilities to pay lease payments. The absence of this information means that fund managers and analysts were not able to properly compare companies that borrow to buy assets with those that lease assets.

The adoption of MFRS 16 has a positive impact on EBITDA. A company shall recognises leased assets even if the company does not legally own these assets as well as the lease liabilities pertaining to the obligation to pay future lease payments. This will result in a gross-up of the balance sheet and cause a deterioration of debt ratios and return on assets. These lease assets and liabilities are then amortised periodically in the form of depreciation and interest expense over the tenure of the lease. As illustrated in *Figure 1*, the adoption of MFRS 16 will have a positive impact on EBITDA as lease expense, which is typically fixed monthly payment and charged as part of operating costs, will be replaced by depreciation and interest expense.

Figure 1: Income statement impact

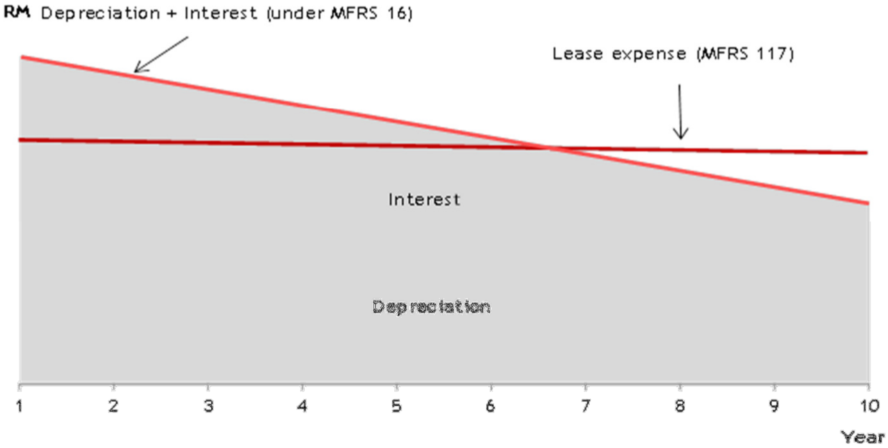
	MFRS117	MFRS16
	Operating leases	All leases
Revenue		
Operating costs (excluding depreciation and amortisation)	Lease expense	
EBITDA		
Depreciation and amortisation		Depreciation
EBIT		
Finance costs		Interest
Profit before tax		

Source: MFRS, MIDFR

MFRS 16 introduces volatility to earnings for a company holding a single lease contract. While the depreciation expense is typically charged on a straight-line basis, the interest expense reduces over the period of the lease as lease payments are made. This results in a reducing total expenses trend as individual lease matures (*refer to Figure 2*). Over the lease tenure, the total amount of expense recognised is still the same as under the old lease standard. Hence, earnings under MFRS 16 will be higher if the standard was adopted at the time where the lease is close to maturity. While MFRS 16 may introduce volatility to earnings for a company holding a single lease contract, the difference in the total expenses between MFRS 16 and previous standard is expected to be insignificant for companies holding a portfolio of leases that start and end in different reporting period.

MFRS 16 affects key financial metrics. Most investors rely primarily on earnings performance to make investment decision. Investors often focus directly on the financial statement analysis process by using reported earnings to estimate free cash flow. In this regard, EBITDA is regarded as a good proxy for cash flow as it removes the impact from capital structure, tax and management decisions. As a result of the adoption of MFRS 16, financial statement analysis that relies on measures of EBITDA would be misleading. Therefore, the use of this metric as a measure of financial health without in-depth review will make companies appear more attractive.

Figure 2: MFRS 16 may introduce volatility to earnings



Source: MFRS, MIDFR

Retail, airlines and healthcare industries are expected to be impacted the most. Based on PwC's global lease capitalisation study, which objective is to identify the impact of the new leases standard, the sectors that are likely to experience the most impact on their performance measures from the adoption are:

i) **Retail** – Retail companies' business model usually premise on leasing of retail space

ii) **Airlines** – Financing aircraft through off-balance models has been a well-established practice in the industry

iii) **Healthcare** - Health care companies lease a diverse range of assets from hospital space and manufacturing space for drug compounds

MFRS 16 impact was first seen in 1QCY19 earnings. Subsequent to the 1QCY19 result season, we observed that, among the stocks under our universe coverage, **Aeon Co (M) Berhad (NEUTRAL; TP: RM1.60), AirAsia Group Berhad (BUY; TP: RM3.29) and KPJ Healthcare Berhad (NEUTRAL; TP: RM0.98)** earnings are impacted the most. The conclusion is consistent with the aforementioned sectors identified by PwC.

Companies demonstrated improvement in EBITDA performance post MFRS 16. Taking cue from 1QCY19 earnings, the three companies mentioned above registered significant improvement in EBITDA when compare to pre-MFRS 16 period. For instance, Aeon Co's reported 1QFY19 EBITDA improved by about +59.3%yoy and +20.0%qoq while AirAsia registered a turnaround in performance from LBTIDA of -RM147.9m in 1QFY18 compared to EBITDA of RM717.4m in 1QFY19.

Most companies opt for modified retrospective application. In adopting MFRS 16, companies are permitted to choose either to opt for a full or a modified retrospective approach. Using the former, a company treats their lease portfolio as if the new standard has been in place previously. This provides investors with more information because it requires the restatement of the previous years' financials under the new rules. Nonetheless, more than 90.0% of companies under our coverage, including Aeon Co, AirAsia and KPJ, chose the latter approach where no restatement of prior period comparative information was made.

Companies appear significantly more attractive with the effect of MFRS 16. To assess the positive impact the accounting standard has on companies' 1QFY19 EBITDA, we compare the reported 1QFY19 EBITDA (with the effect of MFRS 16) and the 1QFY19 EBITDA (excluding the effect of MFRS 16). The reconciliation workings are as shown in *Figure 3*. Our analysis revealed that Aeon Co and AirAsia experienced a substantial increase in EBITDA of about +45.2% and +168.2% respectively post the adoption of MFRS 16.

Figure 3: Impact on income statement post MFRS 16

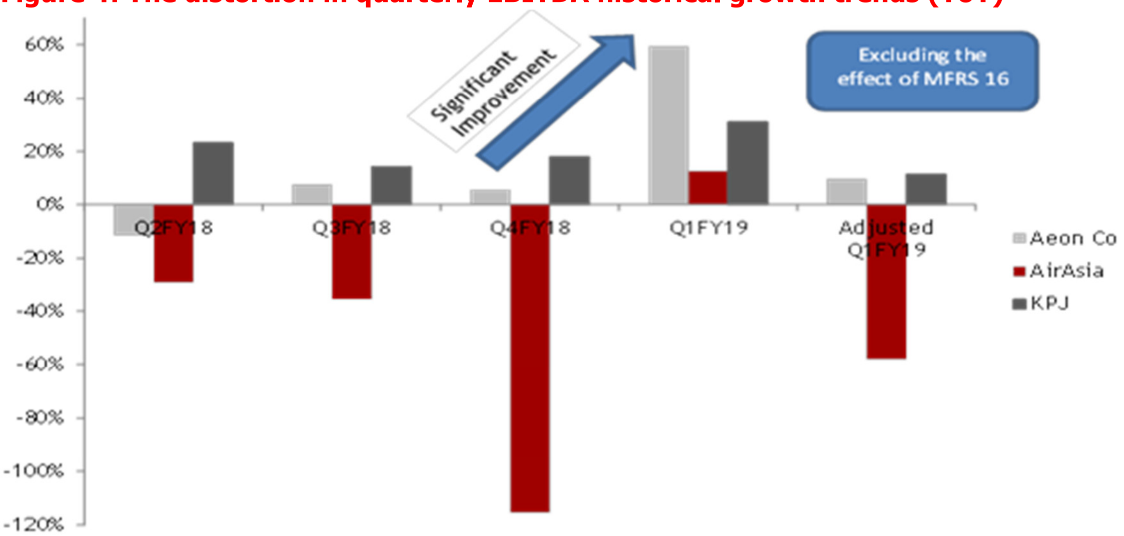
Impact with MFRS 16 (All in RM'm unless stated otherwise)	Aeon Co	AirAsia	KPJ
1Q FY19 EBITDA excluding MFRS 16	145.8	267.5	131.9
Add back: Lease expense	65.8	449.9	23.0
1QFY19 EBITDA with MFRS 16	211.6	717.4	154.9
EBITDA impact (%)	**45.2**	**168.2**	**17.4**
1QFY19 PBT excluding MFRS 16	57.5	252.6	69.4
Add back: Lease expense	65.8	449.9	23.0
Less: Right-of-use asset depreciation	(41.0)	(381.2)	(10.3)
Less: Lease interest	(26.6)	(106.9)	(15.8)
1QFY19 PBT with MFRS 16	55.7	214.3	66.4
PBT impact (%)	**-3.1**	**-15.2**	**-4.3**

Source: Company, MIDFR

The relative immaturity of companies' lease portfolios led to lower 1QFY19 PBT. In contrast to EBITDA, 1QFY19 PBT of Aeon Co, AirAsia and KPJ was lower, subsequent to the adoption of MFRS16. From our analysis, the three companies' PBT was lower by about -3.1%, -15.2% and -4.3% respectively (*refer to Figure 3*). This was mainly attributable to higher depreciation and interest expenses being charged under MFRS 16 as compared to the lease expense. This is also reflective of the relative immaturity of companies' lease portfolios, as interest expense is usually front-loaded. Moving forward, we anticipate a similar quantum of dragged to PBT in the near to mid-term.

The modified prospective application distorts quarterly earnings historical trend analysis. For historical comparison purposes, we exclude the effect of MFRS 16 from 1QFY19 earnings. We observed that Aeon Co's 1QFY19 EBITDA performance on a year-on-year and quarter-on-quarter normalised to about +9.7%yoy and -17.4%qoq respectively (from +59.3%yoy and +20.0%qoq based on the reported 1QFY19 with the effect of MFRS 16). While Airasia's Q1FY19 EBITDA reduced to RM267.5m (from RM717.4m previously). *Figure 4* illustrates the distortion in quarterly earnings historical trend if the trend analysis were made without excluding the effect of MFRS 16. We also illustrate 1QFY19 EBITDA excluding the effect of MFRS 16. Looking at the historical trend, companies appear significantly more attractive at EBITDA level after taking into effect the new lease standard.

Figure 4: The distortion in quarterly EBITDA historical growth trends (YoY)



Source: Company, MIDFR

Companies with off balance sheet leases recorded increase in assets and liabilities. As a consequence of MFRS 16 adoption, all leases are capitalised by recognising the present value of the lease payments including restoration costs (if any) and showing them as leased assets. Furthermore, as lease payments need to be made over time, a company also recognises a financial liability representing its obligation to make future lease payments. Due to the similar method of measuring leased assets and liabilities, both are often of a similar amount initially. In subsequent periods however, the carrying amount of leased asset is generally decreasing faster (in view of depreciation) than the lease liability in the initial years of lease tenure as a higher portion from the lease payment is allocated to interest expense.

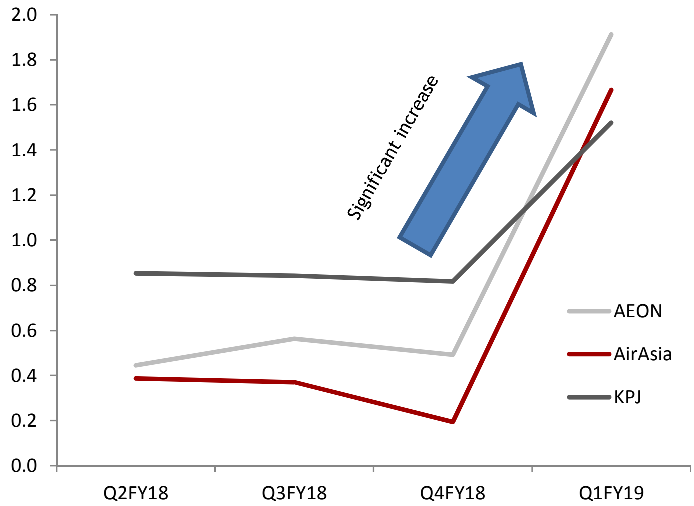
Figure 5: Impact on balance sheet post MFRS 16

Impact post MFRS 16	Aeon Co (%)	AirAsia (%)	KPJ (%)
Assets	39.1	52.7	18.2
Liabilities	80.7	75.4	43.7

Source: Company, MIDFR

The impact to liabilities is more prominent then to assets. We also assessed the MFRS 16 impact on companies from the balance sheet perspective. As seen in *Figure 5*, AirAsia 1QFY19's asset showed the highest movement of +52.7%. On the contrary, Aeon Co's liabilities was inflated the most, increasing by +80.7%. Note that the impact to liabilities is usually higher than the impact to assets. This signals the extent of off-balance sheet financing committed by these companies. Consequently, key financial ratios to gauge the indebtedness of a company such as the debt to equity ratio will also be significantly affected (refer *Figure 6*).

Figure 6: Historical trend of debt to equity



Source: Company, MIDFR

Some companies are yet to adopt MFRS 16 due to the difference in accounting period. Some companies under our coverage have yet to adopt MFRS 16 due to the difference in accounting period. One of the more notable company includes **Padini Holdings Bhd (SELL; TP: RM3.02)** which will only start to adopt MFRS 16 from 1st July 2019 onwards. We are expecting the adoption of MFRS16 to reduce the group's earnings by less than five percent while the balance sheet is expected to show significant impact due to the recognition of off-balance sheet items. This is premised on the assumption that the group is required to capitalise all its 132 stores from 1QFY20 onwards.

The transition disclosures are vital to understand the full impact of MFRS 16. In summary, MFRS 16 would provide a more complete picture of companies' leasing arrangements. The recognition of all lease assets and liabilities in the balance sheet enables a more comprehensive analysis of financial statements. For those companies who adopt modified retrospective adjustments, reference need to be made on the respective notes to financial statements to show the effect of MFRS 16 on earlier financial periods for comparative purposes.

MIDF RESEARCH is part of MIDF Amanah Investment Bank Berhad (23878 - X).
(Bank Pelaburan)
(A Participating Organisation of Bursa Malaysia Securities Berhad)

DISCLOSURES AND DISCLAIMER

MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.